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Earnings management through accrual-based analysis

Case study: Stockmann Oy Abp from 2005-2014

Lua Luong Thi

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Abstract:
Earnings management emerges from accounting discretion that managers allowed to decide for company. Earnings management is extremely hard to detect and there has not been an ultimate method to detect earning management thoroughly. The thesis seeks to provide general knowledge about earnings management and attempts to apply certain theories and accruals models proposed by researchers (e.g. Jone 1991, Spohr 2004 and Friedlan 1994) to the case study of Stockmann Oy Abp. The literature review is collected from books and major studies (e.g. articles, journals, and working paper) by experts from the field. In the case study, the author decided to conduct an analysis to detect signs of earnings management of Stockmann Oy Abp during financial year 2005-2014 through accruals-based analysis. First of all, the author looks into total accruals and discretionary accruals level over 10 year period. Then based on cash flow analysis, the author reasons her choice of further analysis of financial year 2007-2010.

The result showed that total accruals of Stockmann fluctuated widely over 10-year period, and discretionary accruals estimation indicated that during fiscal year 2006-2014, managers have deliberately increased/decreased earnings. In addition, from cash flow approach, financial year 2007-2010 were bought into further analysis. However, detailed break-down of financial statements showed that the divergence in trends of operating cash flows and net income mostly was the result from expansion projects company employed. In addition, manager's incentive to deflate earnings is not strong enough to justify author's suspicion. In a nutshell, the author could not find any indication of earnings management through accrual analysis based on information on consolidated financial statements provided by the company. However, the result contains some limits and is open to further discussion.

Keywords:	Earnings management, Stockmann, accrual, cash flow, net income, financial statement,fianncial accounting
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FOREWORD

I would like to take this opportunity to express my gratitude to my beloved family, for their unwavering love and support through every stage of my life. Especially, to my parents, I cannot imagine how my life would be without the unconditional love and sacrifice I have been receiving from them all these years.

I also want to thank my best friends in Viet Nam and in Finland, for staying beside me through thick and thin, for comforting and encouraging me when I am away from home.

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Helsinki, April 2015

Lua Luong Thi

1 INTRODUCTION

1.1 From the famous Enron scandal

In 2001, Enron Corporation began twenty-first century with huge accounting scandal shook up not only the accounting system in the United State but also all over the world. Before the scandal, the company used to be the 6th largest energy company in the world and was recognized as "America's most innovative company" by Fortune, from 1996 to 2001. Company's shares hit all time high at $90.75 on August 2000 before collapsing to only $0.67 on the first month of 2002. Further investigation charged Enron's executives guilty for fraud, conspiracy and insider trading. The company was accused of providing poor financial reporting, in which profit was aggressively inflated and billions of debts as results from loss in investing activities was hidden from balance sheet. The collapse of the company resulted in $74 billion loss for investors and thousands of employees lost their pensions and their jobs. Further investigation showed how companies exploited accounting loopholes and creative accounting to manipulate reported financial figures. The company once again raised concern over the quality of earnings and earnings management. The Sarbanes-Oxley Act, which provided new standards for U.S company board, public management and accounting firms, was established as authorities reacted to the accounting scandals, especially after Enron case.

1.2 To author's interest in thesis topic

Together with Enron, worst accounting scandals appeared to have all manipulated their financial reports, especially through fraudulent acts to inflate earnings and sales. Despite the fact that authorities attempted to provide more elaborate accounting guides to mitigate those incidents, there are always room for managers to practice their own judgments in preparing financial reports. Earnings management which emerges from those judgments is a prolonged topic of interest among researchers. Even though earnings management is a complicated issue, the author wishes to trigger awareness about this issue at early stage. In this bachelor thesis, the author proposes the thesis topic:

"Earnings management through accrual-based analysis: Case study: Stockmann Oy Abp from 2005-2014"

In which the author attempts to answer **research question**:

"Can total accruals analysis detect signs of earnings management in Stockmann during fiscal year 2005-2014?"

Sub-questions:

- Are there any abnormal accruals in Stockmann's financial reports?
- Are managers' incentives to manage earnings consistent with the abnormal accruals reported?

1.3 Aim of study

The thesis topic seeks to raise basic awareness of earnings management concept for accounting students at bachelor level. It also serves as a foundation study for the author and her peers, who wish to continue their researches in the topic later at higher studies. Stockmann case study is analyzed by applying theoretical framework into real-life practice. The ultimate objective of the case study is to find out, through accruals analysis, indications of earnings management in Stockmann during fiscal year 2005-2014, especially during financial year 2007-2010. From figures conducted from published financial reports and annual reports and basic accruals theory studied by previous researches, the author will discuss and answer research questions and its sub-questions in order to deduce the final conclusion.

2 LITERATURE REVIEW

2.1 Financial statement disclosure

2.1.1 The need of financial statement

Accounting is important, as Horngren et al (2012, pg.26) call it "the language of business". To be specific, accounting serves as an aid to communicate effectively between various departments within a company, as well as with external parties. Accounting is needed since the moment a business starts because it helps transform raw data into

standard form of report is understandable and comparable within a company or within other companies in an industry. Aside from presenting financial information about past transactions, the accounting system also serves as a useful tool for users to forecast business' future. Financial accounting, along with management accounting, is one of the two fields in accounting. Financial accounting produces financial statements for outside audiences. Financial statements can be simply perceived as business documents that report on a business's condititon in monetary term (Horngren et al 2012, pg.2). The whole sets of financial statements are balance sheet, income statement, cash flow statement and notes and explanatory materials to the account. However, it is hard for normal people to get financial statements from private companies, only listed companies are required by law to publish their financial statements. One needs to understand what each item in financial statements is, and it is important to deduce the meaning its number. Hence, financial statement analysis technique is especially needed.

Financial statements are prepared under each country's general accepted accounting principles. However, the increase in cross-border trading activities has urged regulators to create a united set of accounting rules for easier management. Despite the fact that there has not been an ultimate accounting standard yet, international firms usually adopt the United State General Accepted Accounting Principles (hereinafter U.S GAAP) and the International Financial Reporting Standards (hereinafter IFRS).

In 2002, the European Union (hereinafter EU) required that all EU companies, which were listed on regular market adopt IFRS in their financial statements starting in 2005. (Deloitte, 2013)

2.1.2 Users of financial statements

For large companies especially those that are listed on stock market, the published financial statements are mandatory and they serve various types of users such as:

- Company executives: they need an overall financial condition of the company in order to manage the company more effectively and suggest future plan for the company's growth. Internal managers have more insight information in managerial accounting; however, they also need to understand thoroughly financial statements since financial statements represent to public as the overall face of the company.

- Shareholders: are people who will benefit from their investment if the company is doing well and who will suffer loss if the company fails to meet expectation. By reading financial statements, shareholders can get general information such as revenue and profit of company throughout the year and decide whether to continue keeping their shares in company.
- Trade partners such as suppliers who provide raw materials/inventories to the company on credit and customers who purchase the goods/services provided by the company. Suppliers want to know if the company is able to pay its debts while customers need to ensure that company is a reliable supplier (ACCA F3 2013, pg. 198).
- Financial institutions (banks, insurance companies, and so on): Information from financial statements are accessed by financial institutions in order to check whether company meets debt covenant and whether company is able to pay back their debt fully in the future.
- Tax authorities want to know about company's profit in order to assess the tax payable that the company is due to pay.
- Company's employee also needs to know about the current status of their company because their future depends on it.
- Analyst experts need information for their clients who need consulting service before they invest in a company.

2.1.3 Qualitative characteristic of Financial Statements

Financial statements in a nutshell are utmost resources that investors can obtain from the company. There are four main qualitative characteristic for accounting information, which are:

- Comparability: accounting information from financial statements must be comparable with information from its previous periods statements or from other companies that apply the same accounting policy
- Understandability: Though it is important for users to have a strong knowledge of accounting and background information about the company, financial statements must be prepared in a way that users can understand. For this qualitative characteristic, authorities have seeking to reduce the unnecessary complexity of

financial statement. However, many critics still claim that this matter has not been thoroughly fixed. In PWC's discussion paper in 2011 entitle "Point of view: reducing complexity: our proposal to address this challenge", authors pointed out that it was hard for audiences to comfortably understand and optimize financial information because of complexity in financial reports. The negative effect from this issue could cost investors and companies a lot of money. The paper also proposed some solutions for this issue such as developing key principles, establishing advisory committee, and converging international financial reporting standards.

- Relevance: Financial statements are relevant when information users are able to use information from those reports for decision making (ACCA F1 2013, pg. 200). According to Conceptual Framework for Financial Reporting 2010 issued by International Accounting Standards Board (2010) (hereinafter IASB), materiality is mentioned as an aspect of relevance. Information is said to be material if decision made by users will be affected greatly without them.
- Faithful representation: IASB (2010) proposes to replace "reliability" with "faithful representation". Faithful representation reflects accurately information it is supposed to present. According to Conceptual Framework for Financial Statements 2010 QC12, complete, neutral and free from error are three characteristics of faithful representation.

2.2 Accrual accounting and judgment in financial reporting

2.2.1 Cash accounting and accrual accounting

There are two accounting basis: cash-basis accounting and accrual accounting. Cash-basis accounting records revenues only when cash is received and records expenses only when cash is paid (Wild et al. 2011, pg.95). Apparently there are no receivable, payable and depreciations in cash-basis accounting. Cash accounting is not approved by generally accepted accounting principles (neither the U.S GAAP nor IFRS) (Wild et al 2011, pg.95). Accrual accounting records transactions as soon as they occur. That means revenues are recognized when earned and expenses are recorded when incurred (Horngren et al. 2012, pg.131). The majority of companies reports financial statements on accrual

basis. Experts also claim that accrual accounting provides better understanding of company's performance than cash-basis accounting. Richardson et al., (2001) suggest that accrual-basis accounting helps to realize expected future benefits and obligations incurred over a period. However, due to the fact that accrual accounting deals with future cash, it is somehow subjective and involves a number of assumptions (Palepu et al 2003, pg.7). Managers who are in charge of preparing financial statements have to make judgments over various accounts such as how much depreciation cost for each year, how much receivables should be charged as bad debts, or how many inventories are supposed to be obsolete and so on. In theory, managers should use their skills and best knowledge of their company to make the estimation. However, in practice, do those adjustments reflect precisely company's situation or managers have incentives to falsely report incorrect data?

2.2.2 Accounting principles in accrual accounting

- The revenue recognition principle

According to Horngren et al. (2012, pg. 133), the revenue recognition principle states that revenue is recorded "when it has been earned- but not before". Horngren et al. (2012, pg.133) also say that: "revenue has been earned when the business has delivered a good or service to the customer". Under revenue recognition principle, revenue can be realized before or after cash is received.

Palepu et al. (2003) clarifies two criteria in which revenue should be satisfied as below

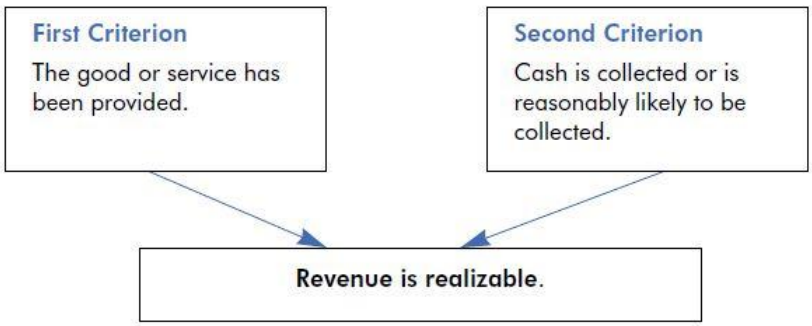

Figure 1: Criteria for realizable revenue (Palepu et al. 2003, pg.222)

- The matching principle

The matching principle serves as guidance for recording expense under accrual accounting. The matching principle states that expenses should be recorded when it incurred during an accounting period, and then they should be matched against the revenue of that period (Horngren et al. 2012, pg.134)

- The conservatism principle

Subramanyam and Wild (2009, pg.77) gives the simple understanding of conservatism principle in accrual accounting as the act of "reporting the least optimistic view when faced with uncertainty in measurement". Horngren et al. (2012, pg.313) says conservatism principle suggests that you "anticipate no gains, but provide for all probable losses". For example, under conservatism principle, expenses should be recorded when "there is a decline in the future benefits expected to be generated by resources" (Palepu et al. 2003, pg. 250). From the matching principle and the conservatism principle, Palepu et al. (2003, pg.250) have listed three criteria for expense recognitions as follows:

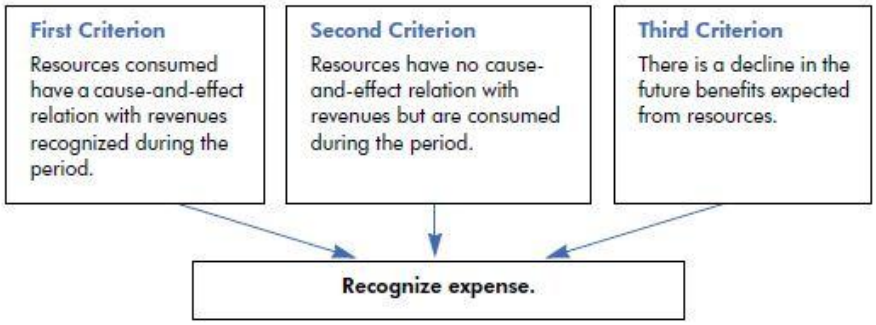

Figure 2: Criteria for recognizable expense (Palepu et al 2003, pg. 250)

Under cash-basis accounting, net income and net cash flow are exactly the same. However, under accrual accounting, following the revenue recognition principle and the matching principle, revenues and expenses are recorded even when there is no cash transaction, subsequently creating a difference from net cash flow. The accounting term for this difference is accruals, in which Subramanyam and Wild (2009, pg.82) defines as "the sum of accounting adjustments that make net income different from net cash flow". Hence apparently the trace of earnings management, if any, can be found in accruals.

2.2.3 Net income: the bottom line

Net income is the result of operation where revenue exceeds expenses (Horngren et al, 2012, pg.12). Rosenbaum and Pearl (2009, pg.34) deem net income as "the earnings available to equity holders once all of the company's obligations have been satisfied". Net income (or net loss) is reported at the end of income statement, hence net income can also called "the bottom line".

Experts are divided over which figure is the most reliable indicator of company's financial health. Sloan (1996) suggests that cash flows are less subject to error and manager bias than accruals incurred in earnings. Graham and Dodd (2009, pg. 397) also prefer free cash flow over earnings; they claim that by focusing on cash flow, investors can avoid the risk of false earnings report. However, despite the warnings about manipulated earnings, recent studies still show that CFOs believe earnings to be the most important figure that public considers (Graham et al. 2005). Dichev et al. (2013) surveyed 169 CFOs from public companies in the U.S and 94.7% thought earnings to be important to very important for investors in valuing a company. In fact, stock market also reacts the same way. Stock prices reflect investor's expectation about company. Investors buy more stocks if they expect that company to grow in the future. On the other hand, they will sell their shares if they deem no future benefit from current firms. Especially the disclosure of net income can severely affect stock price. For example, on March 27, 2015, Blackberry published its quarterly financial report in which the company earns $28 million profit, or 4 cents per share, beating forecast of 4 cents loss per share. Even though sales declines 32% to only $660 million, shares closed that day in New York raised 1.75% to $9.46. Even though, in stock will be adjusted after more analysis, this immediate reaction reflected investor's favor toward earnings index in their trading activities.

Since both internal sources (CFOs and managers) and external sources (investors) value earnings above others financial numbers, net income has proved to be an essential, if not the most important index in financial statements.

2.3 Earnings management

2.3.1 Definition

Scott (2003, pg. 368-369) defines earnings management as an act of selecting accounting policies from a set of accepted accounting rules to get favorable results. Another popular definition comes from Healy and Walen (1999), in which they provided with the view of standard setters as below:

> "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers"

Earnings, following manager's incentive; can be managed upward (increasing) or downward (decreasing). Earnings management is good or bad? First of all, the root of earnings management comes from the flexibilities in accruals accounting that allows managers to use their own knowledge to enhance the decision usefulness of financial statements (Subramanyam and Wild 2009, pg.108). So basically, earnings management is essential in financial statements. However, when exercise judgments, managers have external and internal motives that eventually drive them to exploit their right and intentionally result in bad earnings management. In fact, based on definition of Scott (2003, pg. 368-369) and Healy and Walen (1999), earnings management is indicated as a sign of earning manipulation; which is an illegal act, and the decline in the quality of earnings report. Under this circumstance, "earnings reports reflect the desires of management rather than the underlying financial performance of the company" (Levitt, 1998).

2.3.2 Researches about earnings management

For years, experts have been trying to figure out the most effective model for detecting earnings management through various approaches. McNichols (2000) proposes three research designs that were most commonly used:

- Researches that focus on estimating the level of discretionary accruals, leaded by Healy model (1985), DeAngelo model (1986), Jones model (1991) and the modified Jones model (1995) by Dechow et al. Those studies originate from the general knowledge about two components of accruals: Non-discretionary accruals

and discretionary accruals. Non-discretionary accruals are "accounting adjustments to the firm's cash flows mandated by accounting standard-setting bodies "(Healy, 1985). Discretionary accruals are "adjustments to cash flow selected by the manager" (Healy, 1985). Based on definitions, it is strongly believed that discretionary accruals measure the degree to which earnings are manipulated by the manager. This thesis is also based on researches from accruals and discretionary accruals.

- Researches that focus on specific accruals: Beaver and Engel (1996), Ahmed et al. (1999), and Beaver et al. (2003) study loan loss provision in banking industry as a source of earnings management. Petroni (1992) discusses earnings management in property-casualty insurance industry.
- Researches that study incentives that result in the appearance of earnings management. For example, Burgstahler and Dichev (1997) find that because manager perceives highly of earnings figure, managers have strong incentive to manage earnings upward. Their tested hypothesis shows that earnings management is frequently appear when companies show signs of earnings declines or loss. Degeoge et al. (1999) consider three benchmarks that managers compare with reported earnings: positive net income, persistent earnings, and earnings forecast. Their research once again shows that managers tend to manage earnings to achieves those three thresholds above.

2.3.3 Earnings management versus Earnings quality

Dechow et al. (2010) defines generally earnings quality or quality of earnings is an extent to which information from earnings can serves as useful tools for decision makers. Earnings management and earnings quality are closely related. In fact, earnings quality can be indicated from the result of earnings management and vice versa. When managers tried to manage earnings to achieve earnings target, apparently firm's financial performance cannot serve as legitimate source for any decision; this is indicating that quality of earnings is low.

2.4 Managers' incentive of earnings management

2.4.1 Bonus scheme

Bonus plan or executive compensation is defined by Scott (2009, pg. 356) as:

> An executive compensation plan is an agency contract between the firm and its managers that attempts to align the interests of owners and managers by basing the manager's compensation on one or more measures of the manager's performance in operating the firm

Bonus contracts usually specify manager's reward on the basis of earnings and share price. The rewards are usually under the form of cash, shares or options. However, on the other hand, this strategy somehow pressures managers to manipulate earnings to receive bonus at the end of financial year. Healey (1985) suggests that managers' adjustment of accruals is affected by income-reporting incentives of their bonus contract and that changes in accounting procedures are associated with modification of their bonus plan. Even if earning for one financial year is so low that nothing can be done to meet expectations, managers are likely to use "big bath" technique to increase the chance of achieving next year's earning target (Healy, 1985).

2.4.2 Debt covenant

Debt covenant is an agreement (condition) between firms and its lenders in which certain financial ratios are set by creditors as a benchmark that firms cannot breach. If firm violates the covenant, it is said to be in "technical default" and it is subject to suffer costly effects in which lenders can request immediate payment of loan (Palepu et al. 2003, pg. 88) or increase interest rate (Mulford and Comiskey 2002, pg.61). Typical financial covenants are return on assets ratio, equity ratio, and interest coverage and so on. Since those ratios are calculated from information in the financial statements, managers can somehow manage the numbers. Sweeney (1994) gives the most solid and completed study about managers' attitude toward debt covenant in which she finds out that among firms with the same business levels, managers of firms that are on the verge of violating debt covenant tend to manage earnings upwards than managers of firms that are in control.

2.4.3 Political cost

Big companies supposedly have strong drives to manage earnings in order to appear less suspicious to regulators (Mulford and Comiskey 2002, pg. 07). Jones (1991) suggests that companies are likely to manage earnings downward (using income-decreasing accruals) during import relief investigation by the United States International Trade Commission in order to gain protection when compete with other international companies.

Tax accounts for a major reason this issue, for companies tend to report lower earnings in order to reduce amount of tax they have to pay for the government.

2.4.4 Stock related motives

As mentioned above, stock performance and earnings disclosure are closely related. Companies enjoy the increase in their stocks. Hence, it is expected that those companies will have motive to make their financial statements look good to potential investors. Since firm's first sale of stock to public or Initial Public Offerings (hereinafter IPO), the pressure to make a good impression has always been high. In fact, earnings management happens so frequently during IPO that it has become common knowledge for investors to apply some discount in their valuation process to compensate for expected earnings management (Mulford and Comiskey 2002, pg.80).

Chiraz and Anis (2013) find evidence of earnings management in the first year as public company not in the year before the IPO after studying 139 French IPOs from year 1999 to year 2007.

2.4.5 Managers' reputation

On March 24, 2015, Google announced that Ruth Porat, the most powerful women on Wall Street would join the company as new CFO, following the leave of Patrick Pichette. Before taking the new job at Google, Ruth Porat was Morgan Stanley's CFO and a former contender for deputy Treasury. News of Ruth Porat was immediately celebrated by approximately 3% increase in Google's share price, reflecting investors' trust in the company's future managers. That 3% increase was mainly attributed to her repu-

tation as a successful manager through her three decade stay at Morgan Stanley. This event once again confirms the important of manager's reputation in financial world. Reputation comes hand in hand with result from manager's performance, which reflects on financial statements. Hence, failing to meet forecasted number is often pointed to managerial failure. The consequence, in the worst scenario, can cost managers their jobs. That motivates managers to manage earnings to meet benchmarks and retain their reputation.

2.5 Patterns of earnings management

2.5.1 Big bath

The general idea of "big bath" is if the company is going through a bad earning, the manager may as well record more significant amount of expense to make current financial year even worse. On the other hand, manager hopes that by doing so, in the years later, earnings will be less burdened by those expenses. How can managers afford to do so? Given their right to use judgment, they will deliberately choose income- decreasing accruals in calculating financial numbers such as deferring revenue or accelerating write- offs (Healy, 1985). "Big bath" strategy can easily be excused as the practice of conservatism principle which favors recording lower earnings if there is any doubt. "Big bath" usually happens at the last quarter reports, in which managers have the clear picture of their operation in a year and can confirm that their companies are not going to reach the earnings expectation. Nikolai et al. (2010, pg. 513) suggest that expense charge that is most used in "big bath" technique is impairment loss on long term asset.

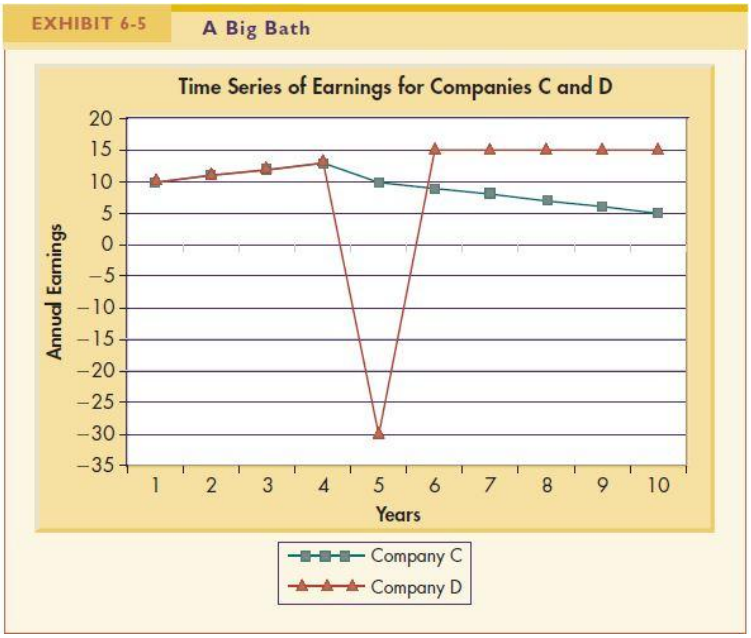

Figure 3: Example of big bath (Stice et al 2010, pg.293)

The illustrated example of "big bath" strategy is present by Stice et al. (2010, pg. 293) in figure 3. In the example, year 5 saw a significant drop in income of company D; however, after year 5, company D experienced steady positive earnings for four years. On the other hand, company C which operates just like D, records consecutive declined earnings for 5 years. Investors may easily fall into this earnings management trap and prefer D instead of C.

The practice of "big bath" strategy has been proved by many studies:

Jordan and Clarks (2004) examined 100 Fortune companies that have same earnings level prior to 2002 to see effect of new- adopted accounting rule SFAS no.142 to companies. At the year of adoption (2002), SFAS no.142 states that initial write downs taken that year would be reported as change in accounting principles, consequently would not affect operating results. Any write down in the following years will be treated as operating expense. The study divides companies into two groups: group 1 which includes companies that recorded goodwill impairment in 2002 and group 2 which includes companies that did not. Jordan and Clarks (2004) find that companies in the first group records significant lower earnings than the other in 2002. In addition, the first group also experienced significant higher rate of negative earnings in 2002 whilst both group had similar rates of firms with negative earnings in 2001. The result from this

study showed that this new accounting rule has given companies an opportunity to practice earnings management in the year of adoption.

Other studies suggest big write-offs often happen when there is a change in management teams. New managers can excuse those write-offs as offset for their predecessor's fault. Levitt (1998) mentioned large restructuring charges as one of "big bath" technique. Tokuga and Yamashita (2011) also found evidence of potential "big bath" tactics in case of Nissan Motor Company in 2000. Following the change in Chief Operating Officer (COO) was a large business restructuring reserve (-232.692 Million Yen) for a new business plan. Research showed that the company endure huge loss in the fiscal year ended March 2000, but achieve a "V-shaped recovery" immediately in period where the new manager started.

2.5.2 The cookie jar reserve

It is a strategy where managers deliberately increase or decrease earnings in order to "smooth" the reported numbers throughout financial years. One of the trick is to reserve a portion of earnings in the good years (put it into a cookie jar) and post those into bad years so as there will not be a huge different in income through the years. Thus, investors or regulators should be aware of companies that report consistent earnings over time. Additional analysis should be taken to find out if those companies are actually using this earnings management technique.

In 2010, Dell was fined $100 million for engaging in the fraudulent accounting. The company practically used "cookie jar" reserves to cover for its shortfalls in operating results between fiscal year 2002 and 2005. The cookie jar reserves reserve was created by "exclusivity payments" from Intel Corp. in exchange for not using Intel's big rival Advanced Micro Devices. The SEC claimed that without this strategy, Dell would have missed every quarter earnings estimate during 4 year period. The SEC also claimed that at their peak, exclusivity payments from Intel accounted for 76% of Dell's quarterly operating income.

2.5.3 Creative acquisition accounting

McKee (2005) named this technique "Big bet on the future": This earnings management techniques happened when a firm acquires another company. When recording this kind of business activity into financial statements, managers can choose to:

- Writing off in-process R&D cost for the companies acquired: This expense will be recorded as one time charge at acquisition year, hence reduced burden for future earnings.
- Integrating acquired company's earnings into parent company's consolidated earnings: If the acquired company is doing well, this act will help boosting acquirer's earnings.

2.5.4 Revenue recognition

Earnings management through revenue recognition such as creating fake revenue, changing time in recording revenue: premature revenue recognition or deferred revenue recognition are common ways that falls into this earnings management technique.

2.6 Real earnings management

Take a look at Scott (2009, pg.403) definition of earnings management:

> Earnings management is the choice by managers of accounting policies, or actions affecting earnings, so as to achieve some specific reported earning objectives.

One can see that there are two channels of earnings management. The first channel that managers use to manipulate earnings is through real activities or real earnings management. Real earnings management happens when managers make decisions about operating activities. Roychowdhury (2006) defines real earnings management as "management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds". By performing real earnings management tactics, managers are aware that they have to sacrifice their future cash flows to achieve short term benchmarks (Hewitt et al, 2014). Real earnings management is more difficult to detect because it involves managers' decision regarding investing and operating strategies (Kothari et al, 2012), thus consequently affects cash flows. However,

Kothari et al also suggests that real earnings management is more expensive than accrual-based earnings management, thus managers tend to attempt to engage in the latter before intervening in "real activities".

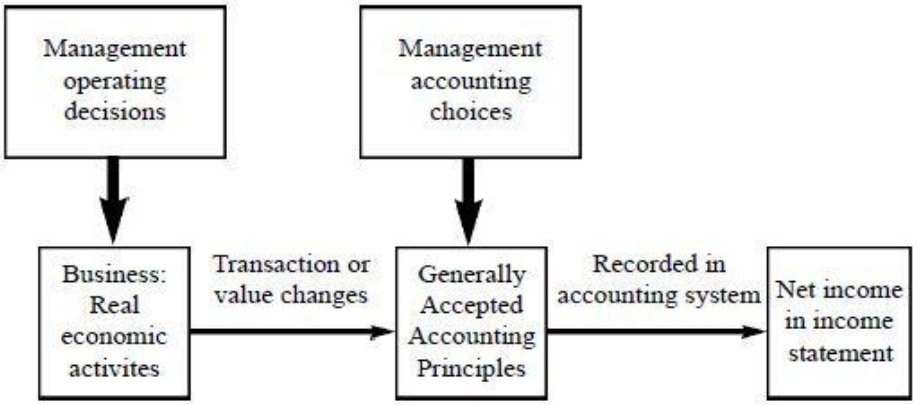

Figure 4: Operating choices versus accounting choices' effect on net income statement (McKee 2005, pg.5)

From the figure above, one can infer the effect of operating choices (in which real earnings management occurs) and accounting choices (in which accrual-based earnings management occurs) on net income.

Real earnings management has been received more attention recently. Graham et al., (2005) conducts surveys and interviews of more than 400 executives in the United State and finds out surprising results that 80% of respondent said that they would use real earnings management to meet earnings target. Kothari et al., (2012) finds evidence that managers use real earnings management in abnormal reduction of Research and Development (hereinafter R&D) to inflate earnings at the time of seasonal equity offerings (hereinafter SEO).

2.6.1 Real earnings management technique

Common techniques used in real earnings management to manage earnings upward (if managers exercise "big bath", they can averse those actions to lower their net income) are:

- Deliberately reduce expense: about 80% respondents in the survey of Graham et al. (2005) choose this method as their first choice. Common discretionary expenses that are reduced are research and development (R&D), advertising, maintenance cost, and so on. Cut off from those accounts especially will not

yield immediate bad effect; however, since it is an essential expense, in the future the consequence of this action will be not being able to create competitive advantage to compete with rivals.

- Sales manipulation: according to Roychowdhury (2006), sales manipulation is the act of temporarily increase sales by offering massive discount or credits to meet sales volume target.
- Overproduction: increase in productions can be claimed as to achieve economies of scales, which in turn lower cost of goods sold. However, too much inventory on hand always carries financial risk in the future.

2.6.2 Accrual-based earnings management

The second type of earnings management arises from choosing accounting policies or accrual-based earnings management. Accrual-based earnings management happens when managers prepare financial reports. It mostly involves choice of accounting principles and the discretion of managers (Kothari et al, 2012). Accrual-based earnings management can somehow be detected through accounting analysis because accrual choices are often guided by general accepted accounting principle such as the U.S GAAP or the IFRS (Kothari et al. 2012). Majority of experts have devoted their studies to accrual-based earnings management such as Healy (1985), DeAngelo (1986), Jones (2001), and Kothari et al. (2005) and so on.

Table 1 provides more details of the difference between real earnings management and accrual-based earnings management as follows:

Table 1: Accrual-based earnings management (Accrual-based EM) versus Real earnings management (Real EM)

	Accrual-based EM	**Real EM**
How?	Through choice of accounting principles	Through real operating decision
In which?	Financial reporting process	Operating activities
Direct cash flow effect?	No	Yes

There are two main types of accruals: current and non-current accruals. Current accruals occur as judgments involve current assets and current liabilities (Palepu et al. 2003, pg.339). Examples of current accruals are estimations incurred while measuring inventories, receivables or payables.

The most important non-current accruals are judgment towards depreciation and amortization charges. Most of the studies in accrual-based earnings managements seek for the evidence of earnings management through current accruals such as Sloan (1996), Spohr (2004), Dechow and Dichev (2012). However, Loftus and Sin (1997) argues that non-current accruals are essential when analyzing the relationship between stock returns and net income. Richardson et al. (2001) also share the same view about the important role of non-current accruals to measure quality of earnings.

2.7 Earnings management through specific accrual account

Under accrual-based earnings management, earnings management incurs from judgments toward accounting policies that managers are allowed to estimate when preparing financial statements. Accounting policies are set by regulators, for example, currently the International Accounting Standard Boards (IASB) is responsible for changes in IFRS and the U.S Financial Accounting Standards Board (hereinafter FASB) is mainly responsible for setting rules in U.S GAAP. However, managers have choices in choosing some certain accounting policies within the law to adjust to financial report. Judgments happen most frequently in these accounts:

2.7.1 Accounting choices toward inventory:

IAS 2, paragraph 6 defines inventory as below

> Inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in process), and materials and supplies that are consumed in production (raw materials).

Relationship between inventory and earnings: Inventories that are sold to customers are then recorded back into income statements under revenue account and cost of goods sold (expense) account.

Judgment in accounting for inventory can be:

Inventory valuation: There are three main accounting methods for inventory: First-in First-out (FIFO), Last-in First-out (LIFO), and weighted average cost. Cost of goods sold is calculated based on those methods. So far, the US GAAP has permitted all three methods while IFRS has abandoned LIFO since 2003.

- FIFO: First-in First-out: Oldest inventories are sold first (Horngren et al 2012, pg.315). Thus, the cost of goods sold is calculated based on the oldest item purchased prices.
- LIFO: Last-in First-out: Newest items are sold first (Horngren et al 2012, pg.315). Thus, the cost of goods sold is calculated on the newest item purchased prices.
- Weighted average cost: Average cost for each item is calculated after each new purchase. This average cost will be applied for all items (Horngren et al 2012, pg.315).

  The issue here is the difference in the old purchased prices and the new ones. Each accounting method can result in different result of cost of goods sold and hence, the gross profit and the net income. Everything holds constant, cost of goods sold under weighted average method will lie between cost of goods sold under FIFO and LIFO. Under GAAP, when price is increasing, FIFO is preferred for income reporting since it will result in lower cost of goods sold and hence higher net income, and LIFO is preferred for tax purpose since higher cost of goods sold will result in lower tax imposed on net income. Under IFRS, managers can choose to calculate cost of goods sold based on FIFO or weighted average cost method. Outsiders should be aware if there is suddenly a change in accounting method for inventory because it might be the sign that managers are trying to alter the cost of goods sold and ultimately alter the net income.

Inventory write-downs: Managers are responsible for estimating when and how to write downs inventories that no longer yields value.

2.7.2 Accounting choices toward long term assets

Depreciation of property, plant and equipment

Property, plant and equipment are non-current tangible assets that are used over the operation of the business. As the business uses the assets, their value and usefulness will be declined. The decline in their value should be recorded as an expense, under depreciation account. The depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset's useful life (IAS 16.50)

Managers are responsible for estimating the useful life and the residual value. IFRS requires that those estimations should be review at least annually and if there is any change in the estimation, they should be mentioned as change in estimate under IAS 8 (IAS.16.51). Managers are also in charge of choosing the depreciation methods, over which the most common are: Straight-line method, the units of production method, and the declining-balance method.

- Straight-line method assign equal amount of depreciation to each estimated useful years (given the useful life and residual amount do not change)
- Units of production method estimate the useful life by units (miles, hours, and so on) and allocate depreciation expense equally.
- The declining-balance method or the diminishing balance method depreciates more at the early stage of the useful life.

Amortization for intangible assets

IAS 38 paragraph 8 defines intangible asset as "an identifiable non-monetary asset without physical substance".

IFRS lists examples of intangible assets are goodwill, intellectual rights (patent, trademark, etc.), and R&D costs.

Goodwill arise in an acquisition when acquiring firm pays a premium over the fair market value of acquired firm's net asset (Mulford and Comiskey, 2002, pg.26). Goodwill usually treated as asset with indefinite life, hence does not need amortization. However, goodwill needs to be revalued annually and be recorded impairment loss when it earn-

ings power declines or completely lost. The amount of impairment loss and time to write off goodwill are up to manager's judgment.

Other intangible assets that bear finite useful lives are subjected to amortization. The amortization method usually used is straight line method. The useful life is subjected to manager's judgment, the longer the useful life, the smaller amortization cost hence the larger reported earnings.

2.7.3 Allowance for doubtful account

Managers should set aside some amount for bad debts. Those can be sales or services already performed on account but are expected to be uncollectible. This account is especially important to banks because banks are practically making profits by giving out loans for customers. Allowance for doubtful account will result in a decrease in account receivable on balance sheet and increase in expense (decrease in net income) in income statement.

2.8 Accrual-based earnings management analysis

2.8.1 Balance sheet approach

The widely accepted definition of total accruals is proposed by Jones (1991). Jones (1991, pg.207) calculates total accruals as "the change in noncash working capital before income taxes payable less total depreciation expense". In her research paper, she used accounting items that matched with those of COMPUSTAT database system to calculate accruals. Based on Jones's definition, Spohr (2004), when studied earnings management around IPO in Finland, offers an alternative equation for Jones (1991)'s formula for total accruals in period *t* (TA) as follows:

$TA = (INV_t - INV_{t-1}) + (REC_t - REC_{t-1}) + (PREEXP_t - PREEXP_{t-1}) - (TRADE_t - TRADE_{t-1}) - (ACCEXP_t - ACCEXP_{t-1}) - (ADVREC_t - ADVREC_{t-1}) - DEP_t$	(1)

INV	Inventories
REC	Receivables
PREEXP	Prepaid expenses and accrued income
TRADE	Trade accounts payable
ACCEXP	Accrued expenses and prepaid income
ADVREC	Advances received
DEP	Depreciation expense

Figure 5: Component of total accrual (Spohr, 2004)

In which: Prepayment: Payment in advanced but not yet incurred.

Accrued income: income that has been earned but not yet received.

Prepayment and accrued income are recorded as assets under current receivables account. When on the date of receipt later, they will then be transferred into income statement under expense item (for prepayment) and income item (for accrued income).

In the case study later, Spohr (2004) formula of total accruals will be exploited. The writer proposes that since Spohr study encounters Finnish companies, the equation is more related to the case study that involves Stockmann later on. In addition, from Spohr's equation one can appreciate specific accounts that are most important account in balance sheet in which accruals deprive from.

Total accruals are the sum of non-discretionary accruals and discretionary accruals. As author mentions in different approaches to earnings management, many researchers (e.g. Healy 1985, DeAngelo 1986, Jones 1991) believe that the trace of earnings management lies within discretionary accruals. There are many researches about discretionary accruals; the most popular one was the Jones model (1991). However, because of limited information about the case study company, in this case analysis, the writer is going to use the Friedlan (1994) model of discretionary accruals.

Friedlan (1994) assumed that total accruals scaled by sales are constant over periods, hence discretionary accruals in period *t* (DA_t) are calculated below:

$DA_t = TA_t/Sales_t - TA_{t-1}/Sales_{t-1}$	(2)

Where DA is discretionary accruals, accruals that subjected to manager's bias and TA is total accruals

2.8.2 Cash flow approach

Cash flow statement is an integral part of financial statements that are required be presented in financial report. Cash flow statement, which meaning can be inferred from the name, deals with activities involve with cash only. Company's main activities are classified as operating activities, financing activities and investing activities.

- Operating activities are the most important activities for any firms. Company's revenue is mainly derived from operating activities. Cash inflows from operating activities are cash received from customers, whilst cash outflows from operating activities are cash paid to suppliers and employees who participating in operating tasks.
- Financing activities are activities related to financial issue such as stock issuance, loan payments or dividend payment. Cash flows from financing activities mostly deal with those accounts.
- Investing activities are activities related to company's investments such as merge and acquisition activities, buying and selling long-term assets.

Subramanyam and Wild (2009, pg.82) consider cash flows from all three activities while analyzing accruals. However, Richardson et al., (2001) justified the exclusion of cash flows from financing activities when calculating accruals. Financial activities such loans borrowed from financial institution normally involves little judgments, hence cash flow from these activities can be eliminated from accruals. Jones and Sharma (2001), Richardson et al., (2005), Dechow and Ge (2006), Bhundia (2012) studied free cash flows (operating cash flow plus investing cash flows) in determining earnings management. Since operating activities contribute a major portion in revenue and income, experts tend to focus mostly on operating cash flow in earnings management analysis through cash flow approach (e.g. Mulford and Comiskey 2005, Ball and Shivakumar 2006, Cheng and Thomas 2006, and Dichev et al. 2013). Apparently accruals are mostly related to operating cash flow for the same reason. Results from Dichev et al ., (2013) survey have shown that CFOs check for the divergence in trends of net income and cash flow from operating activities as first and foremost potential red flag for low quality of earnings. From this perspective, this thesis will focus on accruals as the differences between earnings and cash flows from operating activities.

3 METHODOLOGY

Saunders et al. (2009, pg.136-137) emphasize the importance of research design. They claim that research design gives readers the big picture of how research questions are going to be answered. That being said, a proper research design should specify clearly certain issues such as: author' purpose of research, sources from which data are being collected and analyzed, and limitation of research (Saunders et al. 2009, pg. 137).

3.1 Research strategies

In order to apply theoretical framework into real life situation, the author chooses to use case study as her research strategy. Robson (2002, pg. 178) defines case study is

> A strategy for doing research which involves an emprical investigation of a particular phenonmenon within its real life context using multiple sources of evidence.

Morris and Wood (1991) suggest that by doing case study research, author will have the privilege of understanding research context and how research progress is designed. Yin (2003) proposes two dimensions that classify case study strategies:

- Single versus multiple case study
- Holistic versus embedded case study

While it is clear that single versus multiple case deals with number of case study that is analyzed in the research, holistic case versus embedded case are categorized base on "the unit of analysis". Holistic case study seeks to evaluate the case study as a whole while embedded case study involes analysis of "sub-units" within the organization(s) in which author chooses to examine.

In this research paper, the author choose single case study because to author's knowledge, there has not been any earnings management case study about Stockmann Group, which is one of the biggest companies in Finland. In additional, the case study is supposed to be holistic since it deals with consolidated financial statements of Stockmann and does not involves in any of the Group's specific divisions. In a nut shell, according to Yin (2003), this research paper adopts holistic single case study strategy.

Case study research is often in the sphere of qualitative research. According to Cooper and Schindler (2014, pg.144), qualitative research provides in-depth information that answer "how" and "why" a certain phenomenon occurs. Since the purpose of this study

is to find out if Stockmann managed earnings through accruals account by analyzing how abnormal changes in accruals are consistent with manager's incentive to manage earnings, it is appropriate to identify this research as a "qualitative research".

3.2 Data collections

Secondary data are defined by Saunders et al. (2009, pg. 256) as data that have been collected for analyzing before. Within the realm of this thesis, secondary data are exploited by the author to answer designed research question. Saunders et al. (2009, pg. 258) categorize secondary data into documentary data, survey-based data, and multiple sources. This research paper uses documentary data and multiple- source secondary data:

- Documentary data: major sources of research come from documentary data: books, articles that focus on earnings management, Stockmann's financial reports and annual reports can be accessed on company's website and in Helsinki School of Economics e-library.
- Multiple- source secondary data: Data that are formed from combination of another data set (Saunders et al. 2009, pg. 262). In this research, some of Stockmann information such as current market value and stock price is collected from www.kauppalehti.fi, one of Finland's most famous websites about financial news.

3.3 The credibility of research findings

3.3.1 Reliability

According to Saunders et al (2009, pg. 156), a study is reliable when it shows consistent results when different analysis techniques are used. Saunders et al also suggest that main threats to research findings are errors or biases coming from participants of study or from observers his/her self (see Robson 2012). In this thesis, Stockmann is a subject of research; information about Stockmann's financial reports are audited by KPMG- one of the most prestigious audit companies in the world, thus one can safely say data from Stockmann are reliable. On the other hand, the author uses her best knowledge to

analyze the research. The writer applies literature guidance from experts from the field when deduce the result. Hence, the findings are believed to be reliable because threats are minimized as much as possible.

3.3.2 Validity

Cooper and Schindler (2013, pg. 257) defines validity as the criteria used to evaluate whether research results actually answer research's objectives that were stated at the beginning of the research. Validity contains two forms: external validity and internal validity. External validity or generalizability as Saunders et al (2009, pg. 158) like to call, concerns with the possibility to use research findings to boarder research setting. On the other hand, internal validity reflects how techniques used to analyze research are able to measure what writer claims they do (Cooper and Schindler 2013, pg. 257). Even though this study only focuses on Stockmann Group; however, the findings can also be used as part of larger research such as researches that seek to form techniques to discover earnings management easier and applicable to any firms in general. To conclude, this research fulfills requirements to be valid.

4 LIMITATIONS

Despite the fact that the author tries her best to provide the best result for the research, there are still some limitations that cannot be avoided. Firstly, the scope of earnings management is huge, and there have been many researches that focus on earnings management in specific accounting items. However, in this research, the author wants to deliver a general view of earnings management to readers. The paper seeks to elaborate on this issue with knowledge the writer gains from her encounter with accounting subjects on bachelor level.

Secondly, there has not been a method that can detect earnings management thoroughly. Over the years, experts have been proposing different formulas in the search for signs of earnings management. Most of the formulas proposed by researchers over those years are based on observations from sample companies. Since the number of sample is limited, it also limits the findings. However, among them, there is no completely right or wrong method; hence the formula that the author follows in the case study (Jones 1991,

Friedlan 1994 and Spohr 2004) does not guarantee absolute measurement, but provide basic framework for further studies.

Thirdly, the scope of case study is within the accruals-based analysis. The writer does not deal with real earnings management in her case study because there was not enough sufficient information to investigate this issue.

Fourthly, within limitation of this thesis, the author used cash flow approach to narrow her analysis in four year from 2007-2010 only.

Lastly, the writer understands the quality of this research will be improved if the author conducts a direct interview with case study company (Stockmann). However, due to the fact that earnings management is a sensitive topic, it is expected that companies always deny their use of earnings management. Hence, the author decided not to contact the company, but working on public information instead.

5 CASE STUDY: ACCRUALS ANALYSIS IN STOCKMANN'S FINANCIAL STATEMENTS (2005-2014)

Due to the fact that earnings management is a complicated concept and requires general look for a long term period to understand how company operates and their financial figure trends, in the case study, the author is going to take a look at Stockmann's business profile as well as financial profile over 10 year period from 2005-2014. Accruals analysis is also performed for 10 years period.

5.1 Business profile

Stockmann oy Abp is a Finnish listed company which was established in 1862, engaging in the department store trade, especially retailing, distance retailing and fashion retailing. Since 1942, the group is listed on Helsinki Stock Exchange (NASDAQ OMX Helsinki) under the ticker STC. The Group currently has two types of shares: A (STCAS) and B (STCBV).

At the end of 2014, the company has two divisions: the Department store division and the Fashion chain division. The company operates over 700 stores in 16 countries.

5.1.1 Main merchandise sectors

Fashion and cosmetics account for more than half of Stockmann's business. Others being named are foods, leisure, home and books, publications, stationery. Before its discontinued operation in 2006, Motor vehicles accounted for 23% of Stockmann's total revenue.

Stockmann's revenue distribution changes in sectors for the year 2005(before divesting Stockmann Auto), 2006 (after divesting Stockmann Auto), 2007 (before purchasing Lindex) , 2008 (Lindex fully operated) and 2014 (most recent) as below:

Table 2: Changes in merchanside sectors (Stockmann, 2005 - 2008, 2014) Data on 2014 in fashion sector contained both fashion and cosmetics. X: discontinued division*

Main merchandise sectors	2005	2006	2007	2008	2014
Fashion	38%	48%	53%	66%	68%*
Motor vehicles	23%	X	X	X	X
Foods	13%	23%	16%	12%	15%
Home	12%	10%	11%	8%	7%
Leisure	10%	11%	16%	11%	8%
Books, publications, Stationery	4%	8%	4%	3%	2%

5.1.2 Major divisions over 10 years

- Department store division is the oldest division and accounts for most of Stockmann's revenue. Department store division is to offer customers "an extensive and high-quality product range, a competitive price/quality ratio, and excellent and professional customer service in an inspiring shopping environment with an international ambience" (Stockmann, 2012). Starting since 2015, Department store division will be divided into Retail Division and Real Estate Division.

Figure 6: Stockmann new structure starting from 2015 (Stockmann, 2014)

In 2014, department store division includes Stockmann department stores, the Academic book stores and their online stores (Stockmann.com, Akateeeminen.com), and Hobby Hall. In 2014, Department store division accounts for 60% of Stockmann's total revenue (combination of Stockmann retail and Hobby Hall)

- Hobby Hall was to offer an "easy, reliable and pleasant alternative for buying quality product at affordable prices" (Stockmann, 2008). It was claimed as the largest mail order sales company and leading online store in Finland. Hobby Hall, which used to be an independent division, was integrated into Department Store Division since 2010.Hobby Hall's revenue for 2014 was €97.6 million. In its annual report in 2014, Stockmann stated that it was looking for new owner for Hobby Hall because the company wanted to focus on its online store at Stockmann.com. Hobby Hall's assets were listed under assets available for sale in the financial statements.
- 11 Stockmann beauty stores, which used to be a part of Department Store Division, were expected to be closed down by the end of May 2015.
- Fashion Chain Division has been set up since 2012, including company's own fashion brand: Seppälä and Lindex. In 2015, due to unsuccessful business, the company decided to sell Seppälä under a management buyout which is led by Seppälä's current CEO Eveliina Malentjeff. The transaction is due to take place

on April, 2015. That leaves only Lindex and its online store Lindex.com was the company flagship in Fashion Chain Division in 2015.

- Lindex, which is promoted as an inspiring affordable fashion for fashion-conscious women, was purchased by the Group since fourth quarter of 2007. At the time of acquisition, Lindex has 364 stores in Sweden, Norway, Finland, the Baltic countries and the Czech Republic. By the end of 2014, number of Lindex stores has totaled 491 stores. Ever since its integration, Lindex has played a key role in Stockmann's business. The brand has shown consistent performance and carried the Group through financial crisis. Lindex's revenue for 2014 was € 650.6 million, accounted for 35% of Stockmann's total revenue. The brand is deemed to have an indefinite useful life due to high brand awareness (Stockmann, 2014). In the new restructuring project in 2015, Lindex is one of the core businesses that Stockmann will be focus on. The brand will be operated independently with the new Board of Directors. Lindex's goal is to become an international world-class fashion brand and continue to expand to international market.
- Real Estate Division is expected to operate starting from 2015. This division was result from the split of Department Store Division, the other one being the Stockmann Retail. The unit is responsible for the properties owned by the Group in Helsinki, St Petersburg, Tallinn and Riga (Stockmann, 2014). This division will manage administration and property service provided to all tenants at all department stores. According to Chairman Kaj-Gustaf Bergh (Stockmann, 2014), the establishment of Real Estate Division will help maximizing the value of its property assets and providing more transparency into financial reporting. Market revenue for Real Estate Division at the beginning of 2015 is € 908.3 million (Stockmann, 2014).
- Stockmann Auto that offered "a very wide range of high quality car makes and models" was one of the Group's divisions until March, 2006. The division operated for 100 years before being divested in 2006 (Stockmann, 2006)

5.1.3 Customer markets

Since the start of the financial crisis in Europe, Stockmann was forced to close down many of its divisions and stores. However, currently the Group still has over 700 stores in 16 countries.

- Finland: major revenue of the Group is attributable to customers in its home country. Before the acquisition of Lindex, about more than 70% of the Group's revenue comes from Finland. However, after the purchase of Lindex and thanks to Lindex's favorable customer base, Sweden and Norway have contributed a remarkable potion to Stockmann's revenue. In 2014, only 48% of Stockmann's revenue comes from Finland (Stockmann, 2014)
- Sweden and Norway: Customer gain in those two Nordic countries is the result from the acquisition of Lindex. In fact, in 2007, Sweden and Norway only contributed 3% of total revenue for Stockmann (Stockmann, 2007). However, since 2008, after Lindex fully operated under Stockmann's ownership, the number has increased immediately into 26% (Stockmann, 2008). In 2014, Sweden and Norway accounted for 28% of the Group's market (Stockmann, 2014)
- Russia: As the country's neighbor, with population of 143.7 million people (2014), Russia has inevitably become potential market for Stockmann. In fact, for the past 10 years, Stockmann has aggressively expanded its business in Russia. The company has total 7 department stores in Moscow, St Petersburg and Ekaterinburg. From 2005 to 2014, Stockmann has opened 4 department stores, of which the biggest investment was the Nevsky shopping centre in St Petersburg. In 2005, Stockmann purchased 10,000-odd square metre commercial plot in the heart of St Petersburg and constructed a full – scale department store (Stockmann, 2005). The Nevsky shopping centre, which was completed in 2010, is the largest one in Russia, comprising of 20,000 square metres. Total expenditure for the project was € 185 million (Stockman, 2010)

5.1.4 Loyal Customers

"Loyal customers are the cornerstone of Stockmann's success" (Stockmann, 2009). In 2014, loyal customers account for 75% of Department Stores' total revenue. According

to Stockmann (2014), the Group has about 8.4 million loyal customers. Aware of this competitive advantage, Stockmann has created Loyal Customer Cards with exclusively discounts and benefits. In 2008, Stockmann issued International Stockmann MasterCard with a credit facility. Nordea Bank will be the Group's partner for credit activities in Finland and Baltic countries whereas Citibank will be responsible for those activities in Russia.

On the other hand, loyal customers are also awarded with shares option. In 2006, a maximum of 2,500,000 share options was announced to be granted without consideration to loyal customers purchasing from 1st January 2006 to 31th December 2007 with total amount at least € 6,000. The program continued to carry into new two year period starting from 1st January 2008 to 31th December 2009, and another one from 1st 2012 to 31th December 2013 with the same scale and requirement.

5.1.5 Stockmann's strategy from 2005 to 2014

From 2005 to 2012: Stockmann followed a profit-driven strategy by expanding stores internationally especially in Russia and Baltic countries. However, in the year 2013 and 2014, due to extreme economics difficulty, the Company claimed to pursue cost-saving program. Cost-saving program was implemented by cutting jobs, and closing unprofitable stores in Finland and other countries. To be more specific, in 2014, Stockmann announced to close 11 beauty stores in Finland starting from 2015. Seppälä decided to close 16 remaining stores in Russia, 41 stores in Finland and completely withdraw from Latvia and Lithuania. Cost saving target for financial year 2013-2014 was successfully achieved.

5.1.6 Risks from its business profile

- Financial risks: In its financial statement, the Group clearly stated its major financial risks are currency risk, interest rate risk, liquidity risk, financing risk and counterparty risk (Stockmann, 2014). There is a sector call "financial risk management" in its financial statements, where those risks are explained as basic reasons for company hedging strategies that result in expense in financial statements.

- Sector risks: Stockmann operates under retailing industry, in which fashion is the company's bread and butter. Fashion is unpredictable: the trend can quickly come and quickly fade away, and which used to be popular this year apparently does not guarantee next year's sales. In addition, there are four seasons in a year, which requires completely different products. On financial perspective, fashion business requires careful inventory management. Since inventory in fashion industry can easily become obsolete and is forced to write-down in financial report, managers always need to take into account inventory ratios such as level of inventory and inventory turnover ratio.

5.1.7 External factors that affect the business

- Financial crisis: The financial crisis hit the Euro-zone and Finland in 2008 apparently affects Stockmann's business. The prolonged economic downturn still shows no sign of improvement, purchasing power remains low. In Finland, the retail market shows weak demand and has been struggling for the past 5 years.
- Online-shopping: Technology is rapidly changing the way people shop. Now people can stay at home, browse the Internet and order products from literally all over the world. Finland is not an exception, for 2013 report showed that online purchase by Finns grew 9% (TNS Gallup, 2013). Another report published in 2014 show that one in five Finns shop online every month (Postnord, 2014). This new shopping trend challenges Stockmann to find a new method to adapt to this change. Even though the company has five online stores (including Hobby Hall), Stockmann has long been known for its focus on traditional shopping. Its huge property assets, particularly department stores was to provide customers excellent shopping experience, is now in need of reform and restructuring to gain back competitive advantage.
- Russia: As mentioned above, Russia is not only an important market to Stockmann but to Finland in general. Russian makes up the largest portion of Finland's foreign tourists. However, 2014 saw the collapse of Russian currency ruble to an all-time low due to low oil-price and economics sanction against the country. At the end of 2014, the ruble has lost approximately 50% of its value against the US dollar compared to beginning of 2014. With the ruble becoming

worst-performing currency in 2014, Russia faced the worst scenario of a new 1998 crisis where the country was forced to default. Apparently in 2014, Stockmann suffered a huge lost not because of declining in sales, but also because of currency translation difference.

5.2 Financial profile

During 10-year period, Stockmann has gone through many changes in structuring: aggressive expansion projects through building construction, acquisition, along with division divestment and mass closure of many stores recently due to economic depression. One can see that the external factors play an important role in operating result of Stockmann, especially since euro-zone crisis. Hence, the fluctuation in financial figures can be understandable and hence, the sign of earnings management is harder to measure.

On April 26, 2015, market capital of Stockmann on Helsinki stock exchange is approximately €535.36 million. At current date, the company has approximately 60,000 shareholders and 15,000 employees. The group's revenue in 2014 is about €1844.5 million, total assets is €1936.5 million. In 2014, earnings per share plunged to €-1.39, and the company did not pay any dividend.

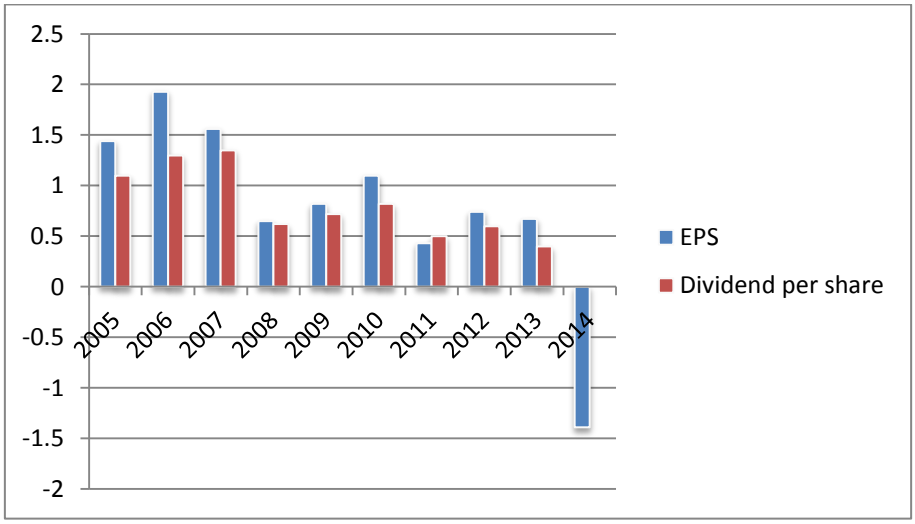

Figure 7: EPS and dividend per share paid from 2005-2014 (Stockmann 2005-2014)

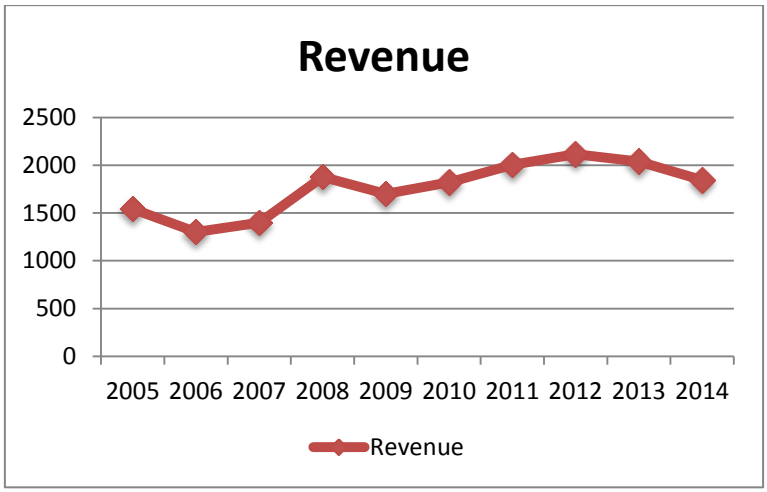

Figure 8: Revenue over 10 year (Stockmann 2005-2014)

Table 3: Gross margin (% of revenue) (Stockmann 2005-2014)

Gross margin (% of revenue)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	35.5	40.5	43.4	48.3	48.1	49.9	48.7	49.5	48.6	46.6

$$\text{Gross margin (\%)} = \frac{Revenue - raw\ materials\ and\ consumables\ used - changes\ in\ inventories}{Revenue}$$

Gross margin helps to infer how much gross profit the company can get from sales. Gross profit is revenue excluding cost of goods sold, in this case Stockmann denotes that cost of goods sold is raw materials and consumables used and the changes in inventories. Apparently the higher gross margin is the better. It means that firms are able to sell products/service at much higher price compared to what they paid for inventories. Higher gross profit provides more sufficient funds to pay for other expenses such as employee salaries or other operating expense. From table 3, the gross margin of Stockmann gradually increased from 2005 to 2008 due to the divestment of unprofitable Stockmann Auto in 2006, and the acquisition of well-operating Lindex in 2007. Other changes in the year later might be because of the company's inability to sell products at higher price margin. Since revenue of Stockmann is in billion euros, the small changes in gross margin will considerably affect profit margin of the company.

Table 4: Cash and cash equivalent in million euros (Stockmann 2005-2014)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Cash	18.4	59.2	18.6	34.5	157.8	36.4	33.2	32.2	27.8	25.3

There is a saying: "cash is king". Cash and cash equivalent is company's lidquity. Stockmann keeps cash relatively low compared to a € 2000 million assets. Cash level is low mostly because many has been used up for investing activities. Low level of cash hinder company 's ability to react to some immediate payments needed in short term.

Stockmann set its target of sales growth always above industry avarage. However, the company only achieved the target on 2005 and 2011; from 2006 to 2010, sales growth was in line with industry average. There was not mention of sales growth in comparision with industry growth for the year 2012, 2013, 2014.

Other ratios that Stockmann takes into account when setting its financial target are return on capital employed, operating profit (% of revenue) and equity ratio. Equity ratio was successfully achieved through the period. Among other benchmarks, Stockmann only achieved return on capital employed ratio, operating profit (% of revenue) on 2006. Result on other years remained quite far behind the target.

Table 5: Stockmann long term financial targets (Stockmann 2010)

	Return on capital employed	Operating profit (% of revenue)	Sales growth	Equity ratio
Target 2006-2011	**22%**	**10%**	**Above industry average**	**Minimum 50%**
Actual 2006	22.9%	10%	In line	74.5%
Actual 2007	12.1%	9%	In line	32.6
Target 2008-2013	**Minimum 20%**	**Minimum 12%**	**Above industry average**	**Minimum 40%**
Actual 2008	8.3%	6.5%	In line	39%
Actual 2009	5.8%	5%	In line	44.1%
Target 2010-2015	**Minimum 20%**	**Minimum 12%**	**Above industry average**	**Minimum 40%**
Actual 2010	5.8%	4.9%	In line	43.1%

5.3 Conclusion from company general analysis

From business profile and financial profile analysis has showed that Stockmann did not do well over the past 10 year. Targets were hardly achieved, cash is relatively low. The negative effect from external factors has partly undermined expansion projects that cost companies a huge amount of money.

5.4 Earnings management analysis

5.4.1 Accounting policies change

Since 2005, Stockmann's financial statements have been prepared in compliance with IFRS. Before publishing, accounting figures are required to be audited by trusted authority. The practice of changes in accounting policies and financial statements were audited by KPMG Oy, which is one of the most prestigious audit companies in the world. In its financial statements report in 2010, the group admitted an error regarding the number in financial year 2007-2009. This error occurred in measuring cost of goods sold, which was "calculated too low due to a calculation error". Cost of goods sold was measured from knowledge and experience of company's current situation, as precisely as possible. This error was once again showed the importance of managers' discretionary measurement in financial statements. However, in the note to financial statement in 2010, in "raw materials and consumables used", there was no change for financial year 2008 and little change for financial year 2009 (approximately €0.2 million). That leaves the author question about the claim "too low" for cost of goods sold account. On the other hand, the error, which was corrected in 2010, was claimed to affect inventories, non-interest bearing short-term receivable, equity and non-interest bearing short-term trade payable account. However, it did not explain the changes in prepayment and accrued income (PREEXP) and accrued expense and prepaid income (ACCEXP), which practically affect total accruals calculation. In calculating total accruals, the writer use corrected numbers; however, the table that shows how the error affected items in calculation is presented below:

Table 6: Adjusted accruals component due to accounting error (Stockmann, 2010. Numbers are in million euros

Year	2008	Adjusted 2008	Change	2009	Adjusted 2009	Change
INV	220.3	**220.7**	0.4	196.1	**196.7**	0.6
REC	152.2	**151.1**	-1.1	131.6	**129.3**	-2.3
PREEXP	28.2	**19.1**	-9.1	24.2	**22**	-2.2
TRADE	95.2	**95.5**	0.3	91.7	**91.7**	0
ACCEXP	80.5	**79.6**	-0.9	73.8	**73.5**	-0.3
Advances received	0	**0**	0	0	**0**	0
Depreciaiton expense	61.4	**61.4**	0	58.4	**58.4**	0

From this accounting error, more attention should be paid in the year 2007-2009

5.4.2 Earnings management from total accrual analysis

The trace of earnings management will be sought from total accrual analysis from Spohr (2004) adaption of Jones (2001) model of total accruals and discretionary accrual model of Friedlan (1994). Under cash flow approach, total accruals are net income less cash flow from operation.

Healy and Walen (1998) confirm the difficulty of a thorough method to identified earnings management. They also suggest that the most conventional way is to match managers' motives against the signs of abnormal accruals. If those two separate studies show consistent patterns, there is high chance that earnings management took place.

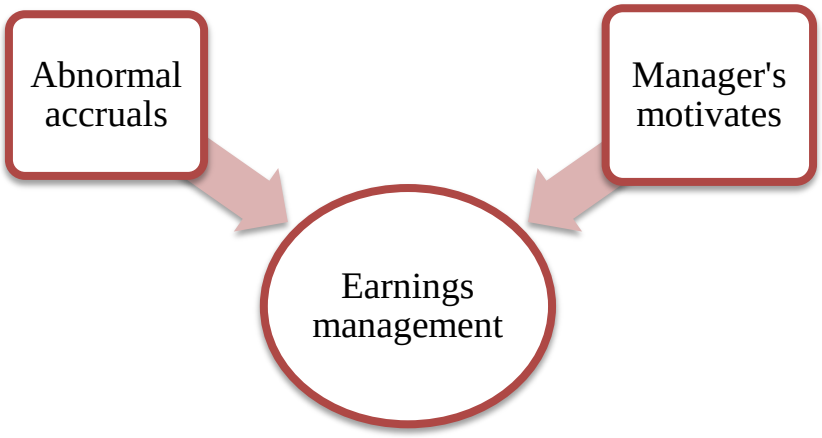

Figure 9: Test of earnings management (Healy and Walen 1998)

5.5 Accruals analysis

Items that are part of Spohr (2004) formula of total accruals and discretionary accrual formula can be found on company's financial statements. The result was shown below: (note that due to lack of information, discretionary level can only be calculated from fiscal year 2006)

Table 7: Total accruals(in million euros) and discretionary accruals ratios

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
INV	195.0	212.0	155.0	244.4	220.7	196.7	240.3	264.7	281.4	285.8	239.3
REC	210.9	210.9	185.9	213.0	151.1	129.3	130.9	135.3	117.3	121.4	83.5
PREEXP	10.7	10.7	5.9	21.6	19.1	22.0	27.1	32.6	33.1	44.7	38.8
TRADE	106.7	90	76	96.1	95.5	91.7	113.9	107.4	121.7	109.7	95
ACCEXP	41	45	38.3	91	79.6	73.5	86.3	87.6	92.7	103.1	92.8
ADVREC	0	0	0	0	0	0	0	0	0	0	0
DEP	31.5	35.8	32.1	36.9	61.4	58.4	61.8	77.7	74.5	74.4	71
Revenue	1445	1542.6	1300.7	1398.2	1878.7	1698.5	1821.9	2005.3	2116.4	2037.1	1844.5
TA		-6.1	-98.2	22.5	-137.5	-91.4	-46.5	-38.2	-94.7	-52.7	-136.3
DA			-0.072	0.092	-0.089	0.019	0.028	0.006	-0.026	0.019	-0.048

According to Stockmann's note to financial statement (2005-2010), prepaid expenses and accrued income were mostly deferred annual account, deferred indirect employee's costs and accrued financial income and expense. On the other hand, main accounts, recorded under accrued payment and prepaid income, were employee benefit expense and mail-order return accruals.

Total accruals can be explained as:

Total accruals for financial year 2005 were €-6.1 million, which meant managers were responsible for judgment of €6.1 million through balance sheet while preparing financial reports for the financial year 2005. The negative sign (-) indicated managers attempted to narrow total assets by choosing accounting principles that reduces accounts on balance sheet.

Total accruals fluctuated greatly over 10 year period. In fact, over 10 year period, Stockmann has gone through many changes in its assets: one huge acquisition of Lin-

dex, many expansion projects in Finland, Russia and other Baltic countries and also stores/division closures. Hence, total accruals cannot justify earnings management yet.

On the other hand, discretionary accrual according to Friedlan (1994) is present under the figure below:

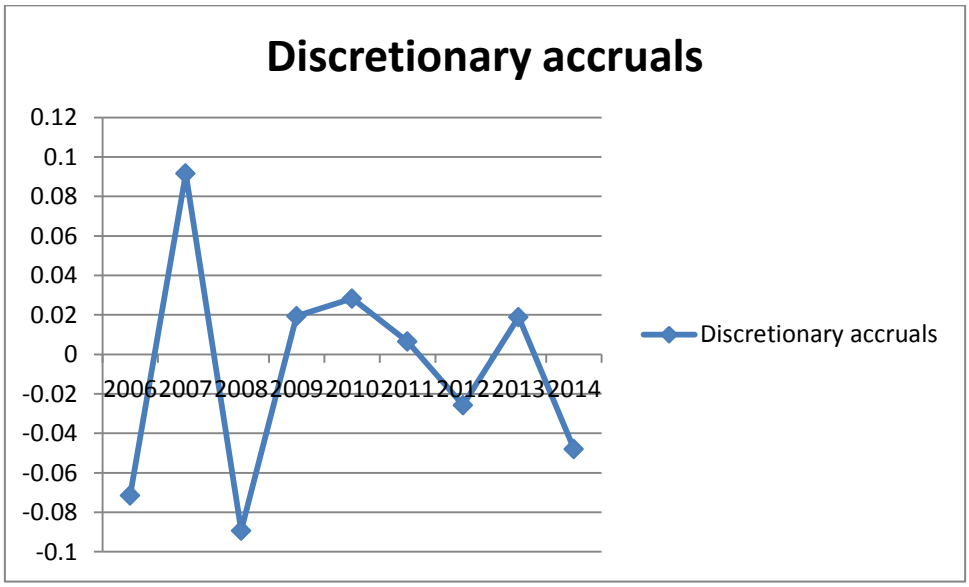

Figure 10: Discretionary accruals (2006-2014)

From model of discretionary accruals, one can see that for five years (2007, 2009, 2010, 2011, and 2013), earnings have been inflated by manager's discretionary choice toward accruals. The other years showed that managers have purposely deflated earnings. For example, in 2007 discretionary accrual was approximately 9.2%, which according to Friedlan (1994) means that earnings has been inflated 9.2%. On the other hand, in 2008, discretionary accrual level was -8.9%, suggesting that managers deliberately manage earnings downward 8.9%.

The author is going to use cash flow approach to find more result:

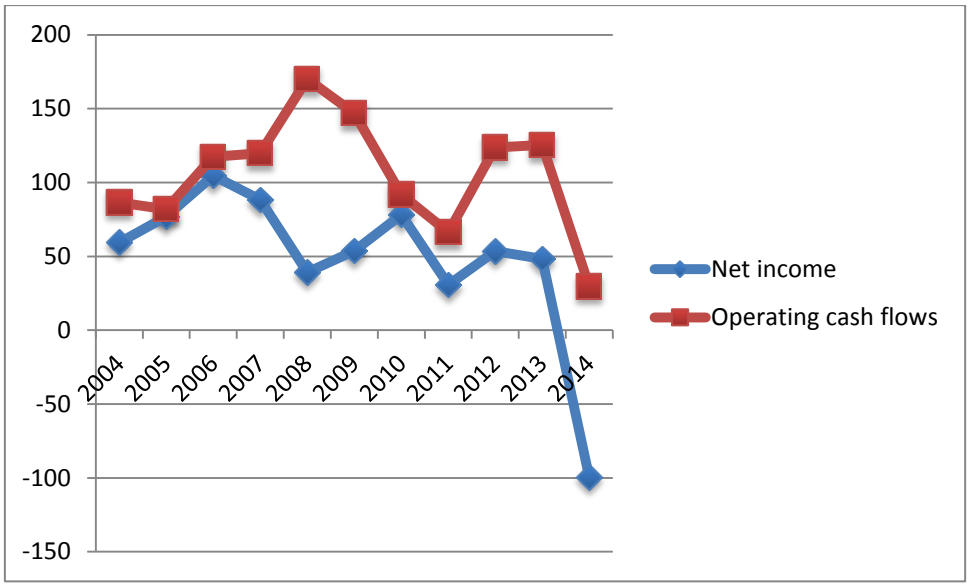

Figure 11: Net income (earnings) and Operating cash flows trend (Stockmann 2004-2014)

According to a survey by Dichev et al., (2013), the first red flag signal that CFOs suggest is the divergence in trends of net income and operating cash flows. In 10-year period, the author observed the sign in four years: 2007, 2008, 2009, 2010. Especially in financial year 2008, operating cash flows reached highest level of €170.1 million whilst income plunged to €39.1 million. Hence, in this report, the author is going to focus on those four years to see if there is any justification for this abnormal trend.

5.5.1 Financial year 2007

Under **balance sheet approach**, total accruals in 2007 were €54.6 million. The figure potentially suggests aggressive management through accelerating assets. In fact, in 2007, the companies announced many expansion projects that eventually lead to the increase in accruals.

Construction projects for 2007 were:

- Enlargement project for department store in Helsinki: estimated cost: €190 million, cost incurred in 2007 : € 51.6 million
- 6 new Nike stores, 7 bestseller stores opened in Russia during the year
- New Department store in St Petersburg: estimated cost €170 million, cost incurred in 2007: €24 million

- Opening Moscow's fifth department store in leased premises, estimated investment : €12 million, expected to open at the end of 2008
- Another full scaled department store in leased premises in Ekaterinburg, Russia: estimated investment €12 million, expected to open in 2009

Biggest event in 2007 is the acquisition of Lindex brand that completed on December 5. Major of the purchase price was financed by interest-bearing loans from financial institutions. At the end of 2007, total assets were €1823.7 million, shooting from only €767.6 million at the end of 2006. Lindex's financial numbers from the next day was immediately combined into Stockmann's financial statements. For approximately one month, Lindex contributed to the group revenue of €54.7 million, operating profit of €15 million. If it was not for Lindex, Stockmann operating profit for the year 2007 will be €110.2 million (down from €125.2 million) and will be lower by €19.4 million compared to that of 2006.

According to IFRS 3, Lindex's assets were entirely integrated into Stockmann's assets; except for that of the subsidiary in German, which was discontinued operation. Hence, portion of changes in total accruals will be justify for Lindex's acquisition.

The most noticeable change is in inventories. At the time on balance sheet, inventories increased by €89.4 million, of which Lindex's inventories account for €76.8 million.

Receivables from Lindex were €14.6 million. Excluding Lindex data, balance sheet at the end of 2007 saw an increase of €12.5 million.

Table 8: Changes (%) in sales, inventories, receivables in 2007 excluding that of Lindex (Stockmann 2007)

	2006	2007	Changes
Sales	1300.7	1343.5	3%↑
Inventories	155	167.6	8%↑
Receivables	185.9	198.4	7%↑

Table above showed the growth in sales, inventories, and receivables of Stockmann excluding those of Lindex. One can see that the 7% increase in inventories and 8 % in-

crease in receivables only accompany with 3% increase in sales. Receivables growing faster than sales might suggest that companies have loosened their credit policy to gain customers.

Prepaid expense and accrual income (PREEXP) and accrual expense & prepaid income (ACCEXP) also grew considerably. Part of this increase can be attributable to the increase in the average number of employees from 10.069 (2006) to 11.161 (2007).

Under **cash flow approach**, there is not a material change in operating cash flow. Although net income decreased from €104.7 million to €88.4 million, fiscal year 2006 included gain of €34.4 million from sales of non-current assets such as the divestment of Stockmann Auto and the closure of Zara in Russia.

5.5.2 Financial year 2008

Under **balance sheet approach**, inventories and receivables are crucial accounts that connected with sales. Total accruals/asset was -5.7%, suggesting that manager might have managed earnings downward. The author will further go into accruals account to see if that was the case.

Table 9: Changes (%) in Sales, Inventories and Receivables 2008 (Stockmann 2008)

	2007	2008	Changes
Sales	1398.2	1878.7	34%↑
Inventories	244.4	220.7	10%↓
Receivables	213	151.1	29%↓

2008 was the first year that recorded full year sales from Lindex. With the addition of Lindex's sale, revenue skyrocketed 34%, from €1398.2 to €1878.7 million. However, net income plunged 55.8% to only €39.1 million. Gross margin increased from 43.4% to 48.3%; however, vigorous increases in employee expenses and other operating expenses are reasons why operating profit actually contracted. Managers appeared to have deliberately boost sales through some tactics in order to sustain sales level. In fact, Stock-

mann (2008) admitted to have launched price discount campaign at the end of the year to Loyal Customers to gain sales momentum. This strategy explained the decrease in inventories; however, this decline did not appear to be a result from normal operating activity.

On the other hand, receivables decreased considerable amount due to an agreement between Stockmann and Nordea bank to completely transfer responsibility in credit activities from Loyal Customers to Nordea bank.

EUR mill.	2008	2007
Trade receivables not due	62.1	140.9
Trade receivables falling due in 1 – 30 days	8.8	16.8
Trade receivables falling due in 31 – 120 days	1.3	3.9
Trade receivables falling due in over 120 days	3.7	3.5
Total	75.9	165.0

Figure 12: Stockmann's trade receivable 2008 in million euros (Stockmann 2008)

From figure 12, one can see that trade receivables has reduced €89.1 million partly thanks to this agreement. Hence, total declines of €61.9 million in receivables account are justified.

Depreciation and amortization increase can be justified by the increased in non-current assets as a result from acquisition and construction projects.

In a nut shell, changes in accruals are comprehensible, thus there is no clear evidence of earnings management from balance sheet approach.

Cash flow approach: also showed the same concern over the change in operating cash flow and earnings. Looking at the chart of growth trend in operating cash flow and net income, one can see that net income was considerably low in 2008, but growth at a considerable rate in 2009 and 2010. The income chart from 2007 to 2010 showed a big V-shaped line, which added into consideration that manager might have deliberately "taken a bath" in order to reduce some burden beforehand for future earnings.

Based on information about "big bath" technique that was discussed in the literature review, if Stockmann deliberately used "big bath", there must have been abnormal increase in the amount of expense recorded in fiscal year 2008. Given the fact that revenue increased significantly and gross margin also increased, if managers attempted to

"take a bath", other expenses aside from cost of raw materials and consumable must be recorded remarkably high.

	Ref.	1.1.-31.12.2008 EUR mill.	1.1.-31.12.2007 EUR mill.
CASH FLOWS FROM OPERATING ACTIVITIES			
Net profit for the financial year		39.1	88.4
Adjustments:			
Depreciation		61.4	36.9
Profit (-) and loss (+) from sales of non-current assets		-3.5	
Financial expenses		51.7	7.0
Financial income		-1.6	-1.3
Income taxes		32.7	31.1
Other adjustments	20.29	-1.4	1.2
Changes in working capital:			
Change in trade and other receivables		75.6	-11.0
Change in inventories		24.0	-12.5
Change in trade payables and other liabilities		-12.7	8.8
Interest paid		-47.7	-6.5
Interest received		0.8	1.3
Income taxes paid		-48.3	-23.5
NET CASH FROM OPERATING ACTIVITIES		170.1	119.9

Figure 13: Cash flows from operating activities in million euros (Stockmann 2008)

While operating cash flows reached highest level, net income sharply decreased. The main reason is already mentioned on balance sheet approach: the decreases in inventories and receivables are adjusted so that it results in higher operating cash flows. Moreover, increases in financial expenses (for example interest expense on financial liabilities), which decreases net income, is added back to operating cash flow because it does not belong to operating activities (financing activities to be precise). In June 2008, Stockmann issue shares totaled €137.4 million in order to finance debt incurred from the acquisition of Lindex. Hence, interest bearing debt is expected to fall in 2009, thus reducing financial expenses.

Deferred tax liabilities reduced earnings by €27.2 million due to loss on exchange rate of Swedish Krona to Euro. This expense literally does not affect cash flows; hence partly explains why earnings and operating cash flow displayed different trends.

In order to justify the large amount of expense that made net income plummet, the writer will revisit net income statement.

EUR mill.	Ref.	Jan.1-Dec. 31, 2008	% of Rev.	Jan.1-Dec. 31, 2007	% of Rev.
REVENUE	2	1 878.7	100.0	1 398.2	100.0
Other operating income	4	4.2	0.2	9.7	0.7
Raw material and consumables used		969.6		798.8	
Change in inventories, increase (-), decrease (+)		2.1		-7.6	
Raw material and consumables used, total	5	971.7	51.7	791.2	56.6
Wages, salaries and employee benefits expenses	6	350.5	18.7	224.1	16.0
Depreciation and impairment losses	7	61.4	3.3	36.9	2.6
Other operating expenses	8	377.4	20.1	230.6	16.5
		1 761.0	93.7	1 282.7	91.7
OPERATING PROFIT		121.9	6.5	125.2	9.0
Financial income	9	1.6	0.1	1.3	0.1
Financial expenses	9	-51.7	-2.8	-7.0	-0.5
PROFIT BEFORE TAXES		71.7	3.8	119.4	8.5
Income taxes	10	32.7	1.7	31.1	2.2
PROFIT FOR THE PERIOD		39.1	2.1	88.4	6.4

Figure 14: Stockmann income statement 2008 in million euros (Stockmann 2008)

From net income statement, one can see that the main reason to the decrease in the bottom line is mostly due to

- Increase in wages, salaries and employee benefits expense (↑€126.4 million). This account increased 56.4%, while average number of employee also increased 40.4% (from 11.161 people to 15.669 people). This is the result from the integration with Lindex => justified.
- Other operating expense: increased drastically by €146.8 million. One should look for more details under the figure below

EUR mill.	2008	2007
Site expenses	192.9	113.9
Marketing expenses	68.3	44.5
Goods handling expenses	24.3	15.4
Credit losses	1.9	1.9
Voluntary social security	9.0	5.2
Interest income from trade receivables	-5.0	-6.3
Financing income from loyal customer cards	-7.6	
Other costs	93.6	56.0
Total	377.4	230.6

Fees to the auditors

EUR mill.	2008	2007
Auditing	0.6	0.6
Certificates and statements	0.1	
Tax advisory	0.1	0.1
Other services	0.1	0.6
Total	0.8	1.3

Figure 15: Other operating expense in million euros (Stockmann 2008)

Generally site expense and other costs increased the most out of other operating expenses. Site expense increased as the result from

- Loss from the unexpected closure of Slomenskaya department store due to discord over lease agreement
- New Nevsky Centre shopping center in St Petersburg on October
- New Seppälä store in Kharkov, Ukraine
- New Lindex store in St Petersburg, Russia and Saudi Arabia
- Continued construction projects from previous years

There is no information about other costs in other operating expense except the fact that Stockmann recorded an increase of €37.6 million over this account.

- Financial expense: increase €44.7 million

  More details of this account are explained below:

9. FINANCE INCOME AND EXPENSES

EUR mill.	2008	2007
Finance income		
Dividend income on available-for-sale investments	0.1	0.1
Interest income on bank deposits and other investments	1.4	1.2
Change in fair value of financial assets at fair value through profit or loss	0.0	
Total	1.6	1.3
Finance expenses		
Interest expenses on financial liabilities measured at amortized cost	-45.4	-6.2
Change in fair value of financial assets at fair value through profit or loss	-0.3	0.0
Foreign exchange differences	-6.1	-0.8
Total	-51.7	-7.0
Finance income and expenses, total	-50.1	-5.7

Figure 16: Finance income and expense in million euros (Stockmann 2008)

From the figure 16, the major change is due to the increased in the interest expense on financial liabilities. Stockmann (2008) claims this is the interest from loan that the company borrowed for Lindex acquisition in 2007. The decline in interest expense in 2009 is predicted because the company issued stock in 2008 and 2009 in order to pay back debts. The amount of new shares issued in 2007 was €137.4 million.

In conclusion, significant increase in expense was mostly due to increase from new expansion projects and the interest expense from loans.

5.5.3 Financial year 2009

Balance sheet approach

Inventories and Receivables continued to decline. The Group justified the decrease in 11% decrease in inventories as adjustment to slower trend in demand.

After a victorious surge in sales in 2008, the figure slipped back to €1968.5 million, decreased by 10% compared to last year. The drop in sales was reasoned by weaken de-

mand and currencies, and by the closure of some stores such as Smolenskaya in 2008 and Hobby Hall in Baltic countries in third quarter of 2009.

On the other hand, under **cash flow approach**, net income bounced back from last year misery with an increase of €15 million while cash flow from operating showed a decline of €23.3 million. The reason lies in expense accounts, which is largely reduced in financial expenses account by €26.1 million. This reduction was predictable, considering the fact that Stockmann has issued shares in June, 2008 in order to pay back loans borrowed since the Lindex acquisition.

5.5.4 Financial year 2010

Balance sheet approach

Table 10: Changes (%) in sales, inventories, receivables in 2010 (Stockmann 2010)

	2009	2010	Changes
Sales	1698.5	1821.9	7%
Inventories	196.7	240.3	22%
Receivables	129.3	130.9	1%

Both sales and inventories rose as consumer demand gradually recovered from financial crisis. However the 22% increase in inventories only accompanied by 7% increase in sales still showed some concern because most of Stockmann's inventory was fashion clothing, which is very sensitive and can easily become obsolete.

Trade account payable increase 24% can be inferred as a result increasing inventories purchase on account.

Under **cash-flow approach**, cash flows from operation continued to drop significantly by approximately 35% while net income increased 45%. This is mostly due to the adjustment from changes in inventories and income tax paid.

5.5.5 Summary from accrual analysis

From accruals analysis, most of the changes in accruals for fiscal year 2007, 2009 and 2010 are justifiable. However, in fiscal year 2008, the amount of total accruals is exceptionally high and both balance sheet and cash flow analysis can only provide partly reason for this abnormal change. Hence, the author suspects that Stockmann deliberately booked more expenses in the fiscal year 2008 in order to ensure that future benefit will not be negatively affected from those accounts. However, the author could not find exactly which accounts were especially managed.

Another approach should be conducted in parallel with accruals analysis is evaluation of managers' incentive to manage earning. Since financial year 2008 is currently the most suspicious year, in next chapter, more attention toward manager's incentives to manage earnings will be paid upon that year.

5.6 Matching against manager's motivation to manage earnings

From accruals analysis, the writer continues to analyze manager's incentive to manage earnings during suspected years. If the incentive is strong and accruals are high, earnings management might have existed.

5.6.1 Bonus scheme

The group has incentive systems that were revealed in note to financial statements. Bonus offered was recorded as an expense into employee benefit expense account. Bonus was offered in the form of cash and share bonus. The Group matched long term target with main financial ratios that bonus was awarded up on are profit before tax minus that of other operation income, return on capital employed and division's own figures.

Starting from 2008, the bonus was grant based on annual performance evaluation. The focus is on short term objectives (Stockmann, 2008). This action might spur manager's intention to sacrifice long term development to short term growth. Main key ratios are still the same as previous years. However, actual operating results were far below target ever since.

⇨ Managers have motivate to manage earnings upward

5.6.2 Debt covenant

There is no specific mention of debt covenant for Stockmann. However, equity ratio, the ratio that measures the leverage level of company, successfully met the target that Stockmann planed. The only exception was on 2007, this again was justified by the large debt borrowed to pay for the acquisition.

⇨ Author could not link this motivate with particular situation in 2008.

5.6.3 Stock price relative

Stockmann issued new shares in 2008 and 2009. Hence, managers have motive to manage earnings upward to expect higher stock price. In fact, earnings show positive sign in 2009 and share price at the end of 2009 increased 19.5% according to OMX Helsinki (Stockmann, 2009). This supports the concern that managers might have "taken a bath" in 2008. Positive net income information in 2010 brought Stockmann's stock price to a higher level than 2009. To be more specific, share price through the year, according to OMX Helsinki index, rose approximately 18.7% (Stockmann 2010).

In addition, in 2010, key employees were granted share options of total 1.500.000 shares, assumed as compensation for managers.

⇨ Suspect of "big bath" can be explainable to some extent, but not strongly. Further studies should be conducted to have final result.

5.7 Conclusion and suggestions for further studies

5.7.1 Conclusion from accruals analysis and manager's incentive to manage earnings

From the information available, the author still find it hard to infer with complete confident whether Stockmann managed its earnings and if so, whether that was a bad earnings management. The result once again proves the complexity of earnings management and affirms the precedent claims by various researchers that the trace of earning man-

agement is extremely hard to find. According to Friedlan (1994) model of discretionary accruals, which is mostly subjected to manager's bias, Stockmann all showed signs of earnings management through financial year 2006-2014. Moreover, from simple accrual calculation under balance sheet and cash flow approach, the result shows the most concern over fiscal year 2008. However, further study about operating activities and manager's incentive has shown no clear signal to clarify author's assumption of "big bath" technique in earnings management. To be more specific, managers did not appear to have strong incentive to manage earnings downward, and operating activities has explained partly the reasons why net income was so low.

Within the scope of this study, 2008 appeared only to be the year where earnings was still burden from debts from Lindex acquisition, new expansion projects and the early sign of financial crisis.

5.7.2 Suggestions for further studies

However, further studies should be conducted in order to overcome some limitation from author's research.

First of all, the author could not obtain specific accounting policies use to estimate accruals. For example, Stockmann claims to use both FIFO and weighted average method when evaluating value of inventories. However, there was not enough information about how these policies are applied.

Secondly, the author based on the divergence in trends between operating cash flow and net income in order to focus more on financial year 2007-2010. Hence, this thesis lacks in-depth studies for other financial years.

Thirdly, under cash flow approach, the effect of cash flow from investing activities as one source of earnings management has not been taken into account in the scope of this thesis. In fact, experts also have different views about the inclusion of accruals from investing activities in calculating total accruals under cash flow approach. However, this study follows the belief that accruals happen most in operating activities and ignores the effects of accruals in investing cash flow.

Fourthly, the measurement of non-recurring items, which account for a considerable portion of income and expense, was not elaborated because of lack of information provided in the financial statements. In addition, deferred assets liability, which accounted

for a large amount in 2008 but did not affect cash flow was not elaborated because lack of information.

Moreover, since the author uses consolidate financial statements, many items was not explained in details by the company, hence limits the study's findings. Especially gain or loss from extraordinary items, which results from unusual activities for specific year, is not included in consolidated financial statements because IFRS has abandoned requirement to include those activities under separate accounts. Hence, managers have been given potential room for managing company's earnings there.

Lastly, real earnings management, which is another channel of earnings management and is more complicated than accrual-based earnings management, is exempted from this research.

In a nutshell, net income is extremely important factor that reflects company's financial health. However, one should be aware that people's enormous expectation and reaction toward income disclosure might have pressured managers to manipulate the number to deceive readers. As a matter of fact, close inspection of financial numbers will yield lower risks than looking at the bottom line alone.

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APPENDICES

Apendix 1

Details of Stockmann financial figures (Stockmann 2005-2014)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Sales	1543	1300.7	1398.2	1878.7	1698.5	1821.9	2005.3	2116.4	2037.1	1844.5
EPS	1.44	1.93	1.56	0.65	0.82	1.1	0.43	0.74	0.67	-1.39
Net income	76.9	104.7	88.4	39.1	54	78.3	30.8	53.6	48.4	-99.8
Operating cash flow	81.9	117.4	119.9	170.1	146.8	91.8	66.2	123.7	125.4	29.6
Dividend	1.1	1.3	1.35	0.62	0.72	0.82	0.5	0.6	0.4	0

Apendix 2

Operating cashflow 2007 (Stockmann 2007)

	Ref.	2007 EUR millions	2006 EUR millions
CASH FLOWS FROM OPERATING ACTIVITIES			
Net profit for the financial year		88.4	104.7
Adjustments:			
Deprecation		36.9	32.1
Profit (-) and loss (+) from sales of non-current assets			-34.4
Financial expenses		7.0	2.3
Financial income		-1.3	-1.8
Income taxes		31.1	24.3
Other adjustments	20,29	1.2	1.7
Changes in working capital:			
Change in trade and other receivables		-11.0	1.7
Change in inventories		-12.5	5.2
Change in trade payables and other liabilities		8.8	11.2
Interest paid		-6.5	-2.5
Interest received		1.3	1.1
Income taxes paid		-23.5	-28.2
NET CASH FROM OPERATING ACTIVITIES		119.9	117.4

Apendix 3

Operating cashflow 2009 (Stockmann 2009)

EUR millions	12/2009	12/2008
Cash flows from operating activities		
Profit/loss for the period	**54.0**	39.1
Adjustments for:		
Depreciation, amortisation & impairment loss	**58.4**	61.4
Gains (-) and Losses (+) of disposals of fixed assets and other non-current assets	**-0.3**	-3.5
Interest and other financial expenses	**28.4**	51.7
Interest income	**-4.4**	-1.6
Tax on income from operations	**7.3**	32.7
Other adjustments	**-0.4**	-1.4
Working capital changes:		
Increase (-) / decrease (+) in inventories	**27.7**	24.0
Increase (-) /decrease(+) in trade and other receivables	**-1.8**	75.6
Increase (+) / decrease (-) in short-term interest-free liabilities	**7.2**	-12.7
Interest and other financial expenses paid	**-32.9**	-47.7
Interest received	**2.1**	0.8
Income taxes paid	**1.4**	-48.3
Net cash from operating activities	**146.8**	**170.1**

Apendix 4

Operating cashflow 2010 (Stockmann 2010)

EUR millions	1.1.–31.12.2010	1.1.–31.12.2009
Cash flows from operating activities		
Profit/loss for the period	**78.3**	53.8
Adjustments for:		
Depreciation, amortisation & impairment loss	**61.8**	58.4
Gains (-) and losses (+) of disposals of fixed assets and other non-current assets	**0.1**	-0.3
Interest and other financial expenses	**22.8**	28.4
Interest income	**-8.2**	-4.4
Tax on income from operations	**-4.2**	7.3
Other adjustments	**-1.1**	-0.4
Working capital changes:		
Increase (-) / decrease (+) in inventories	**-34.3**	27.1
Increase (-) / decrease (+) in trade and other receivables	**-1.1**	0.4
Increase (+) / decrease (-) in short-term interest-free liabilities	**15.7**	5.8
Interest and other financial expenses paid	**-22.5**	-32.9
Interest received	**0.8**	2.1
Income taxes paid	**-16.4**	1.4
Net cash from operating activities	**91.8**	**146.8**

Apendix 5

Changes (%) in components of total accruals (Stockmann 2005-2014)

Stockmann	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
INV	195	212	155	244.4	220.7	196.7	240.3	264.7	281.4	285.8	239.3
changes		9%	-27%	58%	-10%	-11%	22%	10%	6%	2%	-16%
REC	210.9	210.9	185.9	213	151.1	129.3	130.9	135.3	117.3	121.4	83.5
changes (%)		0%	-12%	15%	-29%	-14%	1%	3%	-13%	3%	-31%
PREEXP	10.7	10.7	5.9	21.6	19.1	22	27.1	32.6	33.1	44.7	38.8
changes (%)		0%	-45%	266%	-12%	15%	23%	20%	2%	35%	-13%
TRADE	106.7	90	76	96.1	95.5	91.7	113.9	107.4	121.7	109.7	95
changes (%)		-16%	-16%	26%	-1%	-4%	24%	-6%	13%	-10%	-13%
ACCEXP	41	45	38.3	91	79.6	73.5	86.3	87.6	92.7	103.1	92.8
changes (%)		10%	-15%	138%	-13%	-8%	17%	2%	6%	11%	-10%
ADVREC	0	0	0	0	0	0	0	0	0	0	0
DEP	31.5	35.8	32.1	36.9	61.4	58.4	61.8	77.7	74.5	74.4	71
changes (%)		14%	-10%	15%	66%	-5%	6%	26%	-4%	0%	-5%
sales	1445	1543	1300.7	1398.2	1878.7	1698.5	1821.9	2005.3	2116.4	2037.1	1844.5
changes (%)		7%	-16%	7%	34%	-10%	7%	10%	6%	-4%	-9%
TA		-6.1	-98.2	22.5	-137.5	-91.4	-46.5	-38.2	-94.7	-52.7	-136.3